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Earnings Stripping

Scott Semer of Torys critiques the IRS's proposed rules (REG-108060-15) under tax code Section 385, which in part provide that instruments issued in certain transactions won't be treated as debt for tax purposes—even if they clearly establish a debtor-creditor relationship. Those rules ''have nothing whatsoever to do with distinguishing debt versus equity,'' Semer writes. ''Instead, they are a regulatory attempt to impose new earnings-stripping rules.''

How to Enact New Tax Laws Without Involving Congress: Analyzing the Proposed Section 385 Regulations

BY SCOTT L. SEMER

After a half century of breathless anticipation, the Treasury Department has released proposed regulations under Internal Revenue Code Section 385, which authorizes the Internal Revenue Service to issue regulations as ''may be necessary or appropriate'' to determine whether ''an interest in a corporation'' is to be treated as debt or stock in whole or in part.

The proposed regulations (REG-108060-15) proceed in three main parts.

Part Debt, Part Equity

The first part exercises the authority granted by Section 385 to classify interests as part debt and part equity, rather than having to determine whether an interest should be treated as either debt or equity in its entirety. This part applies to related taxpayers using a 50 percent threshold to determine relatedness.

While technically unremarkable, the real consequences of this aspect of the regulations may be to cause most disputes between the IRS and taxpayers over debt versus equity to become essentially settlement discussions, with the IRS taking an initial view that the instrument be treated entirely as equity, the taxpayer proposing to treat it entirely as debt, and the parties settling somewhere in the middle with some portion treated as equity and some portion as debt.*

Instruments with a status that is uncertain in some manner, including the vast majority of related-party instruments, may therefore no longer be subject to a ''quantum'' evaluation as to what they are. Instead of the degree of uncertainty helping to determine whether it is in fact debt or equity, the degree of uncertainty may now determine what percentage of the instrument is treated as debt and what percentage as equity.

A ''should'' opinion that expresses a 70 percent to 80 percent confidence that an instrument will be respected as debt, for example, may no longer mean that it is 70 percent likely to be sustained as constituting debt but may instead mean, as a practical matter, that it is likely that 70 percent of the instrument will be treated as debt and 30 percent will be treated as equity, once the IRS and the taxpayer agree to settle the issue.

Documentary Requirements

The second part of the proposal imposes documentary requirements on all related-parties-issued debt, using an 80 percent threshold to determine relatedness. Rather than provide a safe harbor or follow the clear congressional directive in Section 385(b) to ''set forth factors'' that are to be taken into account in determin-

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* Of course, in some unusual situations the positions may be reversed, with the taxpayer arguing for equity and the Service arguing for debt.

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ing whether a debtor-creditor relationship exists, the regulations instead impose a fairly onerous set of record-keeping requirements that are necessary, at a minimum, for an instrument to be treated as debt.

In many respects, particularly in the requirement that every payment and event that requires a decision to be made by the creditor under the agreement be extensively documented, the rules go far beyond what many third-party lenders would do in the course of normal business practices. While some third-party lenders might impose strict documentation requirements on themselves and their borrowers and have lengthy creditor agreements, others don't. Under the proposed regulations, all related-party lenders and borrowers will have to follow the practices followed by the most restrictive and anal lenders.

And even then, it is merely a necessary condition for debt treatment. The documentation itself isn't a ''factor'' that evidences a debtor-creditor relationship.

Advisers who make their living drafting such documentation, including analyses of whether debt is likely to be repaid or not, which is one of the required elements, are secretly rejoicing at the prospect of every related lender and borrower being required to engage their services.

Restriction on Debt Distribution

The third part of the regulations is the most peculiar, and has nothing to do with setting forth factors to determine whether an instrument establishes a debtor-creditor relationship. Instead, the regulations provide that instruments issued in certain transactions—even if they clearly establish a debtor-creditor relationship under any conceivable set of factors—won't be treated as debt for tax purposes.

The primary target of these rules is a straightforward distribution of a debt instrument by a corporation to its shareholders—e.g., a leveraged recapitalization designed to increase the debt ratio of a corporation. The business reason for the distribution or recapitalization is irrelevant.

The fact that a corporation that once had a reasonable debt ratio no longer does, due to changing circumstances, and wants to recapitalize itself to a more typical mix of debt and equity is irrelevant—the corporation is prohibited from doing so.

The rest of the rules in this part are essentially a backstop of the main rule, and cover every conceivable example of a transaction a corporation might engage in to get around the restriction on distributing a debt instrument. Even a straightforward lending of cash to a subsidiary is suspect unless the borrower hasn't made any distributions in excess of its earning and profits for three entire years prior to the loan and doesn't do so for the succeeding three years. Even complying with this six-year limit on distributions, however, isn't sufficient to avoid the rules if the IRS is able to determine that the ''principal purpose'' of the taxpayer was to avoid the rule against distributing a debt instrument.

New Earnings-Stripping Rules

What is fascinating about this last set of rules is that they have nothing whatsoever to do with distinguishing debt versus equity. Instead, they are a regulatory attempt to impose new earnings-stripping rules.

Curiously, at least for those who care about such mundane things as the ''rule of law,'' nothing in Section 385 authorizes Treasury to create what is a new rule against deducting interest by related taxpayers. There is nothing in Section 385 empowering Treasury to craft new earnings-stripping rules, nothing that allows it to prescribe different factors for certain taxpayers it deems to be related and certain taxpayers it doesn't, nothing that allows it to differentiate taxpayers that elect, and that are allowed to elect, to file a consolidated return from those that don't, and nothing whatsoever that allows it to prescribe rules to determine whether an interest in a partnership is to be treated as creating debt or equity.

Put simply, nothing in Section 385 authorizes Treasury to issue rules stating that instruments that clearly would be treated as debt under all relevant factors are nevertheless treated as equity if issued in certain transactions but are treated as debt if issued in other transactions or by other taxpayers. Nevertheless, this is exactly what Treasury has decided to do in the new proposed regulations.

The distinction between groups that file a consolidated return and those that don't is itself quite interesting as it raises questions whether it is a violation of the nondiscrimination provisions contained in the vast majority of the U.S. tax treaties, since foreign corporations that own U.S. subsidiaries aren't allowed to file consolidated returns with those subsidiaries.

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What is most peculiar about these rules is what the point of them is. Issued as part of a broader package of rules designed to curtail ''inversions,'' itself a goal with questionable policy implications, these rules' main application will be in situations having nothing to do with inversions.

In fact, the only policy of these rules is to, it is perhaps hoped by Treasury, increase the tax burden on U.S. corporations with related owners by creating a new interest disallowance rule. It is quite simply a tax increase, and one that is imposed most heavily on foreign investors seeking to invest in the U.S.

Deterrent for Foreign Investment

At a time when the Congress has expressed a desire to encourage more investment in the U.S. by lowering certain tax costs of investing in the U.S. through measures such as the creation of Section 897(l), it isn't entirely clear why a half-century-old code provision should suddenly be used as cover for a regulatory agency to decide that it wants to make it more difficult

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for foreign capital to invest in the U.S., and it is far less clear why such a regulatory agency should be allowed or encouraged to do so.

I keep a small copy of the Constitution on my desk, as reminder of what motivated me to go to law school in the first place. Upon opening it, it doesn't take many pages to get to the section that states that the House—the government body that is most representative and the most ''democratic''—has the power to enact tax laws.

Treasury has asked for extensive comments on their proposed regulations. My comment is that they might want to search around for a similar copy of the Constitution and take a look. It is the very first article.